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TAXABILITY OF STOCK DIVIDENDS AS INCOME

AT the formation of a corporation, five thousand shares of its stock, each of a par value of $100, were issued for $500,000. The business of the corporation was successfully conducted; some of its profits were distributed from time to time to its stockholders, and the balance was carried to surplus account; its net assets came to be worth $1,000,000, so that it had a capital of $500,000 and a surplus of $500,000; the directors believed it wise not to distribute this surplus to the stockholders, but to retain it permanently in the business; they therefore paid a stock dividend of 100 per cent. Thus the surplus was capitalized. A fund out of which dividends might have been paid to the stockholders at the discretion of the directors became part of the corporate capital, and so a part of funds out of which dividends might never be paid.

Before the payment of the stock dividend, the book value of each share was $200. After the payment of the stock dividend, the book value of each share was $100. Before the dividend, a stockholder had, say, one hundred shares; each of these shares had a book value of $200, so that the total book value of his shares was $20,000. After the dividend, this stockholder has two hundred shares; each of these shares has a book value of $100, so that the total book value of his shares remains at $20,000. The stockholder has precisely the same fractional interest in the corporate undertaking that he had before. It is obvious that the book value of a stockholder's holdings cannot be increased a penny by a stock dividend.

From this, many a man in the street leaps to the conclusion that a stock dividend is not income. A two-dollar bill, he says, has been exchanged for two one-dollar bills. This is superficial, — the problem is declared closed before it has been opened.

After *Eisner* v. *Macomber*,[1] the recent decision of the Supreme Court on this matter, was handed down, the stocks of many corporations which were likely to declare stock dividends rose in market value. It may well be that the market value of a stockholder's holdings, as distinguished from their book value, is increased by a stock dividend. This result is produced by a number of considerations operating upon the minds of persons who buy stocks, of which the following may be mentioned:

1. The market value of a stock is determined only partly by the asset or book value; the amount of dividends which is being paid, or which is likely to be paid in the near future, determines the rate of return which a stockholder may expect, and the rate of return is an influential factor in determining market value. A belief that the directors are soon to increase the amount of dividends will usually cause the market value of the shares to increase. Now the financial history of corporations shows that, after a stock dividend is declared, the cash dividends thereafter declared (on the increased amount of stock outstanding) will usually total more than the cash dividends theretofore declared. Thus the stockholder with one hundred shares may have been receiving $8.00 a year per share, or a total of $800; after the stock dividend the rate of cash dividend on his two hundred shares *is likely* to be better than $4.00 a share. Thus the declaration of a stock dividend is a circumstance which frequently produces the same result as is produced when, for any other cause, a belief becomes current that an increase in the dividend rate is at hand.

2. Persons become accustomed to see a share of stock of a particular corporation sell around $200. When a share of that corporation is to be had at $110, there are many persons who do not analyze the matter but feel that they are now getting a share at much less than the normal value. And there is a surprisingly large number of persons who before the stock dividend would have been afraid to buy a share of stock at $200, because the stock was at

[1] U. S. Sup. Ct., October Term, No. 318 (March 8, 1920).

a dizzy height and might have a great fall, and yet, after the stock dividend, would feel quite safe in buying two shares of the stock at $110 a share.

Even if, however, the market value of a stockholder's holdings is increased by a stock dividend, the government did not purport to measure the tax by this increase in market value. The tax was not a tax on the difference between the market value of a stockholder's holdings before and after the payment of the dividend; under the Revenue Act of 1916 it was a tax on the whole cash value of the stock issued as a dividend. Thus if we assume that the stock sold, before the stock dividend, at $200 a share, and that it sold, after the stock dividend, at $110 a share, the stockholder who had one hundred shares of a total market value of $20,000 and now has two hundred shares of a total market value of $22,000, would be subjected to a tax, not on $2000, but on $11,000. These considerations of market value, therefore, are not a legitimate basis for the tax which Congress imposed.

Assume that, in a particular case, there was no increase even in the market value of a stockholder's holdings (and this was the fact in *Eisner* v. *Macomber*). This brings us back to the argument that the stock dividend is not income, *because its payment does not cause an increase in the stockholder's wealth.*

Reflection will show that there is nothing in this argument.

A taxpayer is employed by a solvent corporation which promptly pays its debts. He receives his weekly wage of $50 at one o'clock on each Saturday, when his week's work is done. He is not $50 richer at one o'clock than he was at 12:59. He has been growing richer throughout the week as he was earning the $50. When he received the $50 he exchanged a right for cash. Possibly the cash is worth a little more than the right—it is comforting to have the cash in hand—but the difference in the case supposed is very slight. No one would claim that the government may tax as income only the difference between the $50 and the value of the right at 12:59.

Take the case of a cash dividend. If the corporation with a capital of $500,000 and a surplus of $500,000 pays a cash dividend of $100 a share, the book value of the shares drops from $200 to $100 a share. Instead of one hundred shares of a total book value of $20,000, the stockholder now has $10,000 cash, and one hundred shares of a total book value of $10,000. His wealth has not been

increased by $10,000, and yet no one disputes but that the Government may tax the whole $10,000 cash dividend as income.

There is one case in which a person's wealth is increased by the amount which he receives. That is when something is given to him. If $1000 is given to him, he is worth $1000 more the instant it is received than he was the instant before the receipt. But Congress itself has expressly declared that gifts are *not* income.

It is not profitable to multiply examples. It may well be that a stock dividend is income, although the taxpayer's wealth is not increased at the moment of its receipt.

In *Pollock* v. *Farmers' Loan & Trust Co.*[2] the court held, *inter alia*, that taxes upon returns from investments of personal property were direct taxes and that Congress could not impose such taxes without apportioning them among the states according to population, as required by Article I, section 2, clause 3, and section 9, clause 4, of the Constitution. Thereafter the Sixteenth Amendment was passed providing that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." In the Revenue Act of 1916 Congress declared that "the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation . . . which stock dividend shall be considered income, to the amount of its cash value."[3] In *Eisner* v. *Macomber* the Supreme Court decided, four judges dissenting, that Congress could not constitutionally tax stock dividends as incomes. Mr. Justice Pitney delivered the opinion of the majority. Mr. Justice Brandeis delivered the principal dissenting opinion.

What is the proper mode of approach for the Supreme Court in dealing with the constitutionality of an act of Congress? We do not open any discussion of that great question. If the question were new, it might be urged that the court should interpret the Constitutional provisions to the best of its ability, uninfluenced by any interpretation which Congress may have made, and should

[2] 158 U. S. 601 (1895).

[3] 39 STAT. AT L. 757.

sustain or reject acts of Congress according as they conformed or did not conform to the Constitution so judicially interpreted. But the question is not a new question; the Supreme Court has repeatedly stated that, since it is dealing with the act of a coördinate branch of the government, it will pay great respect to the legislative interpretation of the Constitution, and that no act of Congress will be declared unconstitutional if it is consistent with any reasonable interpretation of the Constitution. Our question therefore becomes this: Was this provision in the Revenue Act of 1916 consistent with any reasonable interpretation of the Constitutional provisions mentioned above?

We should note at once the different methods of taxation which Congress has employed and now employs in taxing trusts, partnerships, and corporations. A trustee takes in the trust income, and distributes the net income to beneficiaries. Here are two acts, — the receipt of income by the trustee, and the receipt of the net income by the beneficiaries from the trustee. Conceivably Congress might have enacted that the trustee should be taxed upon his receipt of income, and then that the beneficiaries should be taxed upon their receipt of net income from the trustee. In a business sense, this would obviously be double taxation, and Congress has not seen fit to make such enactment. As the law now stands, the trustee (under the kind of trust most commonly found, where it is the duty of the trustee to distribute income periodically) simply files an information return, no tax is assessed to him upon his receipt of income, but a tax is assessed to the beneficiaries upon their distributive shares of the net income, whether the income has in fact been distributed or not. Similarly with partnerships. The present law provides that "individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year." That is, Congress does not treat the partnership as an entity separate from the partners, and tax it upon the receipt of income, and then also tax the members upon their receipt from that entity of their shares of net income. Congress adheres to the common-law conception that a receipt by a partnership is a receipt by the persons who are members of that partnership.

But it is otherwise with a business carried on by a corporation. Here there is double taxation. The corporation is taxed upon its income and then the stockholders are taxed (under the present law, for surtax purposes only) upon their receipt of income from the corporation. The stockholder is a different legal unit from the corporation, and Congress is "at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand." [4] Thus, a dividend paid to a stockholder, even out of earnings which the corporation had made prior to March 1, 1913, may, if Congress sees fit, be treated as taxable income of the stockholder. If that which was part of the corporate earnings (remaining after corporate taxes have been paid) is passed on to the stockholder, the asset received is taxable income to the stockholder.

Note again the words of the Revenue Act of 1916. "The term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or stock of the corporation." [5] (The words of the Revenue Act of 1918 are, "A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed.") [6]

But, when the directors of a corporation pay a stock dividend they do not distribute corporate earnings. No part of the corporate assets passes from the control of the corporation to the control of the stockholder.

The nature of the transaction is the very opposite to a distribution of earnings. Dividends can only be paid out of surplus, — they must not be paid out of, and hence impair, the capital. So long as there is a surplus there is a fund out of which dividends may be paid at some future time in the discretion of the directors, and out of which a court may order dividends to be paid, if the directors abuse their discretion. So long as there is a surplus, there is a possibility of dividends. When a stock dividend is paid, that which was surplus becomes capital. A fund available for dividends is converted into a fund not available for dividends. The payment

[4] Lynch *v.* Hornby, 247 U. S. 339, 344 (1918).

[5] 39 Stat. at L. 757.

[6] 40 Stat. at L. 1059.

of a stock dividend is not only not a present distribution of earnings, but it destroys all possibility of a future distribution therefrom.

The payment of the stock dividend does not give to the stockholder as against the corporation any right which he did not have before. On the contrary, the rights of the stockholder are diminished and the rights of the corporation are increased. By the capitalization of surplus, corporate control of the assets is perpetuated. If a court should order directors to distribute corporate earnings, it would be a mockery for the directors to pay a stock dividend.

Mr. Justice Brandeis, however, argued, in effect, as follows: The payment of a stock dividend, in business substance, includes two transactions: (1) the payment of a cash dividend by the corporation to its stockholders, and (2) the return of that cash to the corporation for further stock.

It is submitted that the constitutionality of the provision in question cannot properly be sustained on this ground. A corporation has no authority to pay a cash dividend out of surplus, and make it a condition that the cash be returned in payment for new stock. Once the asset has passed from the control of the corporation to the control of the stockholder, it is wholly for the stockholder to decide what he will do with it. It is true that the corporation may accompany its declaration of a cash dividend with an attractive offer to subscribe to a further issue of stock, but it must permit the stockholder to assign his right to take advantage of this attractive offer. The corporation must really let go of the cash. It may at the same time bid to get the cash back again, but it will be exposed to competition with all other legal units who seek the stockholder's cash. The stockholder, with the cash in hand, is master. He may prefer another investment, or he may feel the need of using the cash to pay his income taxes and debts, or he may spend the cash in the pursuit of happiness.

The financial history of corporations shows that under such circumstances there is usually a lively market in the "rights," and there could be no such market if there were not stockholders who did not choose to return the cash to the corporation. Even if the corporation gets back an amount of cash equivalent to that paid out, it does not at all follow that it is getting it back from the persons to whom it was paid (and sometimes it happens that the

directors were, in fixing the terms, too optimistic about the attractiveness of the rights, and that rights are not exercised either by the stockholder or any assignee).

In *Tax Commissioner* v. *Putnam* [7] the court decided that a stock dividend was income (even though the surplus which was thus capitalized had been earned before the pertinent amendment to the state constitution became effective). The legislature had simply subjected "dividends" to taxation as income, and had not declared that this term should include stock dividends. Therefore on this point (there were other points before the court raising constitutional questions), the primary question was one of the construction of a statute. Prior to that time, the court had had occasion to consider whether a stock dividend was capital or income, and had persistently held it was capital. The prior cases had, to be sure, dealt with questions between life tenants and remaindermen, but lawyers had grown accustomed to thinking of stock dividends as capital and not income, and this was important in determining what the legislature had in mind when it said that "dividends" should be taxed as income. Moreover, taxation statutes are to be strictly construed. As the question before the court was one of statutory construction, one would have expected the court to decide that it was not clear that the legislature had intended to tax stock dividends as income. In *Towne* v. *Eisner* [8] a similar question was presented, the Income Tax Law of 1913 not expressly declaring stock dividends to be income, and the court unanimously declined to sustain the government's contention that a stock dividend was taxable as income under that law. But the Massachusetts court decided (the decision was made prior to the decision in *Towne* v. *Eisner*) that a stock dividend was income under the Massachusetts Income Tax Law of 1916. Mr. Chief Justice Rugg said: "The substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares." [9]

This statement is opposed to the decisions of the Massachusetts court itself in cases arising between life tenant and remainderman. Conceding that there may be some adequate basis for a court, in

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[7] 227 Mass. 522, 116 N. E. 904 (1917).

[8] 245 U. S. 418 (1918).

[9] 227 Mass. 522, 535, 116 N. E. 904 (1917).

declaring what is income, to lay down one rule as between life tenant and remainderman, and to lay down the opposite rule between the government and a taxpayer, that adequate basis cannot be that the business substance of a transaction is one thing when the question is between life tenant and the remainderman, and is the opposite thing when the question is between the government and a taxpayer. Business substance is business substance. It is therefore profitable on this question of business substance to look at the pertinent Massachusetts cases arising between life tenant and remainderman.

Rand v. *Hubbell.*[10] A corporation had voted to allow each stockholder to subscribe to additional shares. The directors declared a cash dividend just sufficient to pay the subscription price, "the dividend to be applied by the stockholders in payment for the new stock created." Each stockholder received a check for the amount of his dividend, and immediately exchanged the check for a certificate of stock; the checks were then destroyed. The court said: "No money was ever paid, or intended to be paid, by the corporation to any stockholder. The declaring of the dividend in cash, and the giving of checks therefor, were mere forms," and it held that the dividend must be treated as a stock dividend.

Hyde v. *Holmes.*[11] A corporation had given to each stockholder the right to subscribe to additional shares. The directors declared a cash dividend just sufficient to pay the subscription price. "It was undoubtedly expected that many if not most of the stockholders would exercise their option by subscribing." But the court declined to treat this as a stock dividend, saying, "Every stockholder could take the money and use it as he chose."

Smith v. *Cotting.*[12] A Massachusetts trust company was prohibited by law from issuing stock dividends. It gave to each stockholder the right to subscribe to additional shares. The directors declared a cash dividend just sufficient to pay the subscription price, "which stockholders may apply if they so desire in payment of new stock." A trustee received the cash and applied it in payment of new stock. The court declined to treat this as a stock dividend and made the trustee accountable to the life tenant for the cash received. The court said:

[10] 115 Mass. 461 (1874).

[11] 198 Mass. 287, 84 N. E. 318 (1908).

[12] 231 Mass. 42, 120 N. E. 177 (1918).

"It is plain that the distribution cannot be deemed as comprising both stock and cash, a stock dividend to share owners who chose to take stock, and a cash dividend to those who chose to take money. . . . Nor can the dividend be called a mere form as in *Rand* v. *Hubbell*, 115 Mass. 461, 477, where the directors voted, that the dividend must be applied in payment for new stock simultaneously created. The money having been deposited in a national bank, separate warrants were sent to the stockholders respectively entitled extra dividend warrant, and stock subscription warrant, which they could indorse if they elected to take stock, or use the dividend warrant if cash was preferred. A stockholder accordingly had the option to use either warrant, and he was not bound legally or morally to take stock rather than cash in payment." [13]

Where a corporation pays a cash dividend to its stockholders and at the same time offers other stock for subscription, *if* the corporation really lets go of the cash, so that it is wholly for the stockholder to say whether he will use that cash in subscribing for more stock or not, there is a transaction which differs radically in business substance from the payment of a stock dividend.

If therefore a stock dividend can be treated as income only on the ground that it is a distribution of corporate earnings, we should conclude that the decision of the majority in *Eisner* v. *Macomber* was right. Congress cannot by its declaration convert a transaction which is not a distribution of earnings into a transaction which is a distribution of earnings.

If we take a literal construction of the Act of 1916, these considerations would end the discussion. For Congress did not make a general declaration that stock dividends should be taxable as income. It said that "dividends" shall be held to mean "any distribution . . . by a corporation . . . out of its earnings . . . whether in cash or in stock of the corporation . . . *which* stock dividend shall be considered income." A demonstration that a stock dividend is not a distribution of earnings makes this enactment, literally construed, abortive so far as stock dividends are concerned. But such a construction is unduly strict. Congress had shown plainly what result it intended to reach, and the statute ought to be given the same effect as though Congress had declared that stock dividends should be taxable as income, and had said no more. Mr. Justice Pitney gave this effect to the statute.

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[13] 231 Mass. 42, 46, 120 N. E. 177 (1918).

This brings us to the great question: May the word *income* reasonably be construed as broad enough to include stock dividends under any circumstances? Our answer would be in the affirmative, and would be based on the following propositions: (1) capital increment may be taxed as income; (2) so far as a stock dividend capitalizes earnings made during the taxpayer's ownership of the stock (upon which the dividend is paid), it is predicated upon facts showing an increment in the stockholder's capital, and the payment of the dividend furnishes a proper basis for taxing such increment. We will consider these two propositions.

(1) *Capital increment may be taxed as income.*

In *Tebrau (Johore) Rubber Syndicate, Limited* v. *Farmer* [14] the Court of Session held that a profit made by a company through the purchase and sale of property was not taxable. Lord Salvesen said:

"I am unable to distinguish the position of the appellants from that of a person who acquires a property by way of investment and who realizes it afterward at a profit. It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income-tax but results from an appreciation of his capital. No doubt if it is part of his business to deal in land or investments, any profits which in the course of that business he realizes form part of his income; but the mere fact that a person or company has invested funds in the purchase of an estate which has subsequently appreciated and so has realized a profit on his purchase does not make that profit liable to assessment."

The court was construing acts (the first of which was 5 & 6 VICT. c. 35) taxing "annual profits or gains arising or accruing to any person . . . from any kind of property."

Gray v. *Darlington*.[15] Congress enacted in 1867 that a tax should be paid "annually upon the gains, profits and income of every person . . . derived from any kind of property . . . In estimating the gains, profits, and income of any person, there shall be included . . . profits realized within the year from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated . . . and all other gains, profits, and income derived from any source whatever." [16] Dar-

[14] [1910] S. C. 906, 911.
[15] 15 Wall. (U. S.) 63 (1872).
[16] 14 STAT. AT L. 477, 478.

lington bought bonds in 1865 and sold them in 1869 at a profit. The court held that he was not taxable on this profit. Mr. Justice Field said:

> "The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits and income. . . . Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital." [17]

Hays v. *Gauley Mt. Coal Co.*[18] The Corporation Tax Act of 1909 (effective January 1, 1909) levied an excise tax based upon "the entire net income . . . received" by each corporation during the period stated. A corporation bought shares of stock before 1909, and sold them at a profit in 1911. A tax was assessed to it on that proportion of the profit which had accrued since January 1, 1909. The Circuit Court of Appeals held this tax to be invalid, relying upon *Gray* v. *Darlington*. But the Supreme Court unanimously held the tax to be valid. Mr. Justice Pitney pointed out the differences in the language of the statute of 1909 from that of the statute of 1867 and said:

> "Since the conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase arising from corporate activities together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as 'gross income.'" [19]

In all three cases, the courts were dealing with the construction of statutes, — no constitutional question was presented. But the decision in *Hays* v. *Gauley Mt. Coal Co.* (which was a decision by a unanimous court) settles the point that the word *income* is a word which is sometimes used in a sense broad enough to include "capital increment." Therefore, if Congress enacts that the capital in-

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[17] 15 Wall. (U. S.) 63, 65, 66 (1872).

[18] 247 U. S. 189 (1918).

[19] *Ibid.*, p. 193.

creases of a taxpayer (occurring since the Sixteenth Amendment became effective) shall be taxed as part of his income, the court should sustain the enactment.

(2) *So far as a stock dividend capitalizes earnings made during the taxpayer's ownership of the stock (upon which the dividend is paid) it is predicated upon facts showing an increment in the stockholder's capital, and the payment of the dividend furnishes a proper basis for taxing such increment.*

Suppose a taxpayer bought one hundred shares of the common stock of the United States Steel Corporation at $50 a share, and after several years sold it at $100 a share. He has made $5000, but he is not worth $5000 more the instant after he made the sale than he was the instant before. His capital — the one hundred shares of stock — has been increasing in value over a period of time. When he realizes his profit, the law fastens upon that act as a proper basis for taxing him upon the capital increment that has occurred up to that time. There is a pause, a rest, a taking account of what has happened up to date.

Unless the court is prepared to say that Congress may not tax capital increment as income, a taxpayer who receives stock as a dividend and sells it becomes liable to a tax upon the proceeds. Mr. Justice Pitney states in his opinion in *Eisner* v. *Macomber* that the stockholder would be so taxable.

Therefore our problem narrows to this: Can capital increment constitutionally be taxed as income *only* when the capital has been sold? There is nothing in the nature of things which justifies such a limitation.

The payment of a stock dividend capitalizes surplus. Assume, for a moment, that the taxpayer to whom the dividend was paid had owned the stock on which the dividend is paid throughout the period during which the corporation earned the surplus which is now capitalized. As the corporation was earning the surplus, the value of the taxpayer's capital — his shares of stock — gradually increased. The payment of the stock dividend was legally permissible only because such surplus had been accumulated. As the stock dividend is predicated upon facts showing a capital increment to this taxpayer, and as the payment of such dividend changes his rights, both formally and in business substance, it would not be unreasonable for Congress to enact that there shall be a pause, a

rest, a taking account of the increment in the taxpayer's capital which has occurred up to date.

In many, if not most, cases there would, however, have been some changes in the ownership of the stock upon which the dividend is declared during the period when the surplus, now capitalized, was being earned. This greatly complicates the matter. Suppose a corporation had been accumulating a surplus from March 1, 1913, to January 1, 1919, and some of its stock was held by A throughout that period, and was sold by A to B on January 1, 1919, and shortly afterwards a stock dividend was paid to B. When A sold to B, he would be taxed on the proceeds, less the value of the stock on March 1, 1913. His profit so determined would probably not exactly coincide with his share of the corporate surplus earned in that period, although the amount of such surplus would be an influential factor. But the important point is that he would be taxed on the capital increment which had occurred up to the time of sale, under a rule which Congress has seen fit to lay down. Now if B is taxed on the full amount of the stock dividend (either on its cash value, as prescribed by the Act of 1916, or on its par value, as prescribed by the Act of 1918), he will be taxed on an increment which has not occurred to *his* capital. And Congress could not constitutionally enact that B shall be taxed as a part of his income for an increase which occurred to the capital of A. When A sold to B, there was a pause, a rest, a taking account of the capital increment up to date. B can therefore only be taxed on the capital increment which occurred after the date when the capital passed into his ownership.

In *Eisner* v. *Macomber* a stock dividend was declared based partly upon earnings before March 1, 1913, and partly upon earnings made after that date. The government sought to tax the stock dividend only to the extent that it was based upon earnings made after March 1, 1913. The record states that on March 4, 1916, Mrs. Macomber owned the stock (upon which the stock dividend in question was paid), but the record is silent as to the date of her acquisition of that stock. If she wished to object to the tax on the ground that the tax was assessed in part upon the capitalization of earnings made prior to her acquisition of stock, it was incumbent upon her to allege and prove that such was the fact.

It is submitted that Congress had the constitutional power, under the Sixteenth Amendment, to tax as income to a taxpayer the par value of stock received by him as a dividend to the extent that the surplus capitalized by such dividend was earned (1) subsequent to March 1, 1913, *and* (2) during the ownership by this taxpayer of the stock upon which the dividend was declared. The tax claimed by the government in *Eisner* v. *Macomber* was within this rule.

To sustain a tax assessed to a taxpayer on a stock dividend paid to him only to the extent that it capitalizes surplus earned during that taxpayer's ownership (of the stock upon which the dividend is paid), would be to sustain the Act only with a limitation, but the court when it can sustain an Act of Congress only with a limitation may well do so, leaving it to Congress to say whether it wishes the act, with that limitation, to continue in force.

For these reasons, and on the facts of the particular case, we believe that the result reached by the minority in *Eisner* v. *Macomber* was the right result.

If we turn from questions of constitutional power to questions of what is wise legislation, we should think that a tax on stock dividends, within the limits defined above, would not be wise.

One groans at the thought of a tax the computation of which would require not only a determination of how much of the capitalized surplus was earned since March 1, 1913, but also a determination of how much of that surplus was earned during the ownership of each stockholder of the stock upon which the dividend was paid. At present the burden upon taxpayers is twofold, — first, to prepare the returns, and second, to pay the taxes. Tax returns are already highly complex; a great amount of time has to be spent to make accurate returns, and the time so spent is sheer economic waste. The complete elimination of stock dividends from the subjects of income taxation will tend to simplicity.

Moreover, Congress may bear in mind that if a cash dividend is paid, it is quite likely to be spent. The payment of a stock dividend, on the other hand, locks up the money, — it makes an addition to the permanent capital of the corporation. This is the kind of act which ought now to be encouraged.

Will the government be crippled by the loss of revenue expected from the taxation of stock dividends? No.

The claim that the decision in *Eisner* v. *Macomber* will allow corporations to escape taxation on their profits may be dismissed as demagogic. The result in no wise affects the taxation of the corporations — it only affects the extent of the double taxation which comes from first taxing the corporation on its earnings, and then taxing the stockholders also because of those earnings.

Even when reckoned in terms of double taxation, and without any change in the law, the ultimate loss, if any, to the government ought to be small. The Revenue Law of 1918, and the regulations thereunder, contemplate that a stockholder who receives stock as a dividend and pays a tax thereon and thereafter sells the stock so received shall not be subject to a tax except to the extent that the proceeds of sale exceed the par value of the stock received. But the regulations also require that a stockholder who receives stock as a dividend and pays no tax thereon and thereafter sells the stock so received shall be subject to a tax on the entire proceeds, and this is confirmed by Mr. Justice Pitney's statement in *Eisner* v. *Macomber*. This decision simply throws all stock received as a dividend into the latter class. The tax will accrue, not when the stock is received, but when it is sold. The inhibition on stock dividends being now removed, they will probably frequently be made, and sales of stock received will follow.

But suppose the stock is not sold. If the stock is given away, or passes upon the stockholder's death to his legatees or next of kin, no tax is, under the present law and regulations, assessed upon the capital increment which has occurred prior to such a transfer. And, if the transferee later sells, he will have a taxable gain or a deductible loss according as the proceeds of sale are greater or less than the value of the stock when *he* received it. This is true of both shares of stock and all other kinds of capital. Thus, there is a great gap in the taxing structure designed to encircle capital increment.

If our taxation laws are to be changed, Congress will seek for taxes which cannot readily be passed on to the consuming public. The country is awakening to the economic fact that heavy taxes on corporate earnings are readily passed on to the consumer — an "excess profits" tax suggests the lancing of swollen wealth, but it does nothing of the kind and is, instead, probably the greatest single factor in the present high cost of living. A tax on capital

increment is a desirable form of tax, as it cannot readily be passed on. Therefore the gap in the taxing structure designed to encircle capital increment ought to be closed.

If a taxpayer acquires capital, and later that capital passes from his ownership, at this point there may well be a pause, a rest, a taking account of the capital increase which has occurred during his ownership of the capital. It should make no difference whether the transfer is for a consideration or without a consideration. The administration of such a law would be simple, and, if the reasoning in this article is sound, it is within the constitutional power of Congress to say that the capital increase shall be taxed as income *whenever* the capital that has increased passes into the ownership of another.

If such a change in the law were made, the ultimate loss, if any, to the government arising from the decision in *Eisner* v. *Macomber* would be offset by a substantial gain, for it is to be noted that this change would be applicable to increases of all kinds of capital, and not merely shares of stock.

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